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Thinking ahead for Europe

The Meaning of Cyprus: Moving towards banking union?

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The root of the problem in Cyprus is well known. Its two major banks had attracted huge deposits from abroad, largely from Russia, and presumably mostly from individuals wanting to escape scrutiny at home. The proceeds were then invested in Greek government bonds and loans to Greek companies. When Greece imploded, these investments went sour and the banks in Cyprus that had engaged in this strategy were insolvent. Given this situation, the logical choice for the country should have been clear: if the government wanted to survive, foreign depositors must bear part of the losses. It is thus difficult to understand why the government of Cyprus was at first so reluctant to inflict any losses on depositors. However, the solution that was eventually agreed makes sense: the two largest banks of the country are effectively resolved. Their bad assets will be separated and wound down over time. Neither the government of Cyprus nor the European taxpayer will put any additional funds in these banks. The losses that remain once the bad assets have been disposed of will thus have to be borne by the creditors of the bank, which in this case means those with deposits of over €100,000.

Although Cyprus is too small to matter for global financial markets, its case could turn out to become a very important precedent for the way European policy-makers deal with future banking problems and the plans for a 'banking union'.

A banking union needs three elements: a single supervisor, a common resolution authority and a credible system of deposit insurance. There are lessons on all three accounts:

The need for a single supervisor that has not been captured by local interests has been once more underlined. The ECB would never have allowed the banks in Cyprus to attract huge deposits by paying above-market interest rates and then to put all of their eggs in one basket (Greece). This was a high-risk strategy without a safety net.

There is still some discussion about how to create a common resolution authority. But events have shown that the ECB has become de facto the resolution authority for the banks in the euro area because a bank in difficulties cannot survive if the ECB does not grant or renew emergency liquidity assistance (ELA). This accumulation of

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power in the hands of a completely independent institution is of course not ideal from the point of view of democratic accountability. But this should constitute an additional incentive for member states to agree to the creation of real common resolution authority with enough funding to be able to resolve in an orderly way even larger banks.

The revolt of the small savers in Cyprus has also underlined the need for a credible system of deposit insurance. The European Directive that establishes that bank deposits have to be protected up to €100,000 does not provide a European guarantee as it imposes only an obligation upon member states to create a deposit insurance system at the national level. In reality, however, the impression has been created that somehow 'Europe' protects small depositors. Until now plans for a common deposit insurance system have not been even on the table because deposit insurance was not perceived as a live problem. Cyprus has shattered this complacency. Leaving deposit insurance exclusively at the national level is no longer an option.

But Cyprus holds also a more general lesson: Given the extreme reaction of financial markets to the bankruptcy of the US investment bank Lehman in 2008, it had become an axiom among policy-makers in Europe that no bank should be allowed to become insolvent. But financial markets did not react negatively to the news that for the first time even depositors in a bank in the EU will lose part of their money. This was noted with glee in Berlin and elsewhere in Northern Europe.

The key lesson for European policy-makers is thus that it is possible to 'bail in' the creditors of a bank. This has not been officially admitted, but it was expressed quite clearly by the President of the Eurogroup, Jeroen Dijsselbloem, who said that after Cyprus, Europe should become more courageous in bailing in bank creditors.

This realisation that the European taxpayer does not have to save every troubled bank might have a very beneficial effect: the German resistance to Banking Union is motivated by the fear that this would mean that the German taxpayer would indirectly have to underwrite the losses of banks in the euro area periphery.

Cyprus represents of course an extreme and special case on many accounts. But the way the problem arose and the solution that was finally adopted might have very important consequences for the way Europe deals with its banking problems.